

Do share-based payments constitute expenditure, for tax purposes, in order to facilitate a deduction?

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**Jeremy Bortz
BRTJER001**

Introduction

The uncertainty surrounding whether a share-based payment constitutes expenditure, is, to a large extent, unresolved. This issue is significant because a company may only claim a (general) deduction in terms of section 11(a) of the Income Tax Act No. 58 of 1962, as amended (The Income Tax Act) if they have incurred “expenditure”.

With the introduction of legislation that imposed a tax on the disposal of capital assets, Capital Gains Tax (CGT), this issue became more significant. In terms of the CGT legislation, a company needs to have “incurred expenditure” in order to deduct the asset’s cost from the proceeds received on its disposal.

It is also relevant with regards to the capital allowance(s) a company may claim, on the acquisition of capital assets, as certain provisions require the company to have a cost in order to deduct a capital allowance. (It is less of an issue in this instance in that section 11(e) of the Act allows a company an allowance on the assets’ value, if cost cannot be determined).

The issue has been brought to the fore with the 2004 introduction, by the International Accounting Standards Board, of a new accounting standard on share-based payments, International Financial Reporting Standard 2 *Share-based Payment* (IFRS 2). IFRS 2 requires an entity¹ to “recognise share based-payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity²”.

The South African Institute of Chartered Accountants (SAICA) has adopted all the international accounting standards and incorporated them into Generally Accepted Accounting Practice (GAAP). All listed companies, in terms of a Johannesburg Securities Exchange (JSE) requirement, have to comply with GAAP, thereby enforcing compliance with this new standard.

¹ The words entity and company, in the context of this article, have the same meaning and will be used inter-changeably.

² International Financial Reporting Standard 2, *Share-based Payment*, paragraph IN3

Most companies remunerate their employees, in part, with the issue of equity. For senior management, especially, the value of the share options granted is extremely large. It is submitted that this new accounting standard, requiring that equity remuneration be expensed, will have a significant impact on the financial statements of any company.

As a result of having to recognise share-based payments; either as an expense in their income statement or as an asset, subject to depreciation, on their balance sheet, companies will seek to deduct these share-based payments for tax purposes. Previously, companies were not concerned as to whether or not they would be able to claim a deduction as no amount was recognised as an expense in their income statement. Since these payments will now have to be reflected in the income statement, however, companies will be concerned about receiving a deduction. The general issue, therefore, is whether companies will be allowed such share-based payments as a deduction in terms of the Income Tax Act: either as a general deduction i.e. section 11(a), or a specific deduction or allowance. The specific issue in this regard is whether a share-based payment constitutes “expenditure” for the company.

The Income Tax Act mentions the word “expenditure” in three contexts. The first is for the purposes of the general deduction formula contained in section 11(a). In terms of section 11(a), a company carrying on a trade is allowed [as a deduction], “expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature”. This paper will firstly address the issue of whether a share-based payment, for revenue assets or for services acquired, constitutes “expenditure actually incurred” for the purposes of section 11(a). The remaining requirements of section 11(a) will not be considered.

The second context relates to capital assets where, in terms of certain provisions, a company must have incurred a cost in order to claim an allowance. The issue is whether a company has a cost if they acquire an asset with the issue of shares.

The third is in the context of Capital Gains Tax (CGT) where, in determining a capital gain or capital loss, a company deducts from the proceeds on the disposal of an asset that asset’s base cost. The term “base cost” is defined in paragraph 20 of the 8th

Schedule and contains the phrase “expenditure actually incurred” [on certain items]. The issue is whether a capital asset, acquired with the issue of shares, has a base cost when sold, i.e.: whether the share-based payment would be expenditure for the purposes of paragraph 20 of the 8th Schedule.

In summary; if a payment for goods and services with an issue of shares constitutes expenditure, then: (1) if a revenue item, the amount(s) expensed in terms of IFRS 2 will be deductible in terms of section 11(a), or (2) if a depreciable capital asset, there will be a cost for the purposes of claiming a capital allowance and (3) it will establish a base cost for CGT purposes, provided in each case that the remaining requirements of each of the provisions are met.

This paper will initially discuss the financial implications of this new accounting standard. Before discussing the tax implications, it will provide a brief background to the requirements of IFRS 2. Whether a share-base payment constitutes “expenditure” for tax purposes will be determined by interpreting any applicable case law, both local and international, and by analysing any relevant legislation. Finally, the international practices of both the UK and Australia will be briefly discussed. (This paper will in no way no consider the valuation, for tax purposes, of such potential deduction).

Financial Implications for Companies

The requirement to expense share-based payments will have a significant effect on the bottom line of a company’s earnings. Irene Christopher, head of policy development at the *Association of Chartered Certified Accountants, Southern Africa*, says that “some analysts have put the overall hit to profits expensing share options as high as 15%”³ while Costa Economou, an actuary at *Alexander Forbes Financial Services*, said that “a 5% decline in earnings per share would not be unrealistic”⁴. This decline is less than what transpired in the United States of America where, as Deloitte audit partner Graeme Berry explained, “in 2001, earnings a share in the US were down as

³ “Companies to adjust earnings for options as ‘gap’ closes”, *Business Day*, Tuesday June 8 2004, p 17

⁴ “Companies face growing pressure on share options”, Financial Accounting IV 2004 handout

much as 10% and in 2000 by 8% as companies expensed their options in preparation for the new accounting standard”⁵.

In some instances, though, the effect may well be more extreme. An article from *Accountancy SA* reports that “Investec reported post-tax profits of R626-m in 2002. The R250-m worth of options issued by the company to executives and staff would have dumped profits by 40% to R276-m”⁶. Alec Hogg, writing for Moneyweb about Nedcor, states that “were the full cost of the options grant brought into Nedcor’s numbers for 2002, the year’s pre-tax profit of R1,68-billion approved by the auditors and reported to shareholders would have been a more modest R1,22-billion. In other words, the reported number is a 27% overstatement of the true position”⁷.

Accounting Requirements

IFRS 2 is effective for periods beginning on or after 1 January 2005. With regards to equity-settled share-based payments, it is applicable to schemes that came into existence on or after 7 November 2002 where they were not yet vested at 1 January 2005. The standard requires an entity to “reflect in its profit or loss [income statement] and financial position [balance sheet] the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees”⁸.

Before discussing the issue, it is imperative to understand the scope of IFRS 2 and what it entails. IFRS 2 defines a share-based payment transaction as a “transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options) or acquires goods or services for amounts that are based on the price of the entity’s shares or other equity instruments of the entity”⁹. In essence, IFRS 2 covers three types of transactions:

⁵ “Companies to adjust earnings for options as ‘gap’ closes”, *Business Day*, Tuesday June 8 2004, p 17

⁶ “Closing the loophole”, *Accountancy SA*, May 2004, pp 12,13

⁷ “Nedcor’s R460m share option orgy”, www.moneyweb.co.za, 8 January 2004, accessed 12 July 2005

⁸ International Financial Reporting Standard 2, *Share-based Payment*, paragraph 1

⁹ International Financial Reporting Standard 2, *Share-based Payment*, Appendix A: Defined terms

- 1) Equity-settled share-based payments: where equity instruments are issued as consideration for goods or services received.
- 2) Cash-settled share-based payments: where liabilities are incurred; cash is paid or assets are given, for amounts based on the prices of the entity's shares or other equity instruments, as consideration for goods and services received.
- 3) Choice of settlement: either the entity, or the supplier of such goods or services, has the choice of whether the entity settles the consideration in cash, or with other assets, or by issuing equity instruments.

The accounting treatment in terms of IFRS 2 paragraph 7 is to “recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction or a liability if the goods or services were acquired in a cash-settled share-based payment transaction”¹⁰. It goes on to say that where “the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses”¹¹.

Where a choice of settlement exists, the accounting treatment depends on what liability exists. Is there a liability to settle in cash or shares and who has the right to decide on the method of settlement? The value to be recognised, as well as the date for such recognition, is dependant on the type of share-based payment, as different rules exist for each of these types. A detailed discussion of the different accounting treatments is beyond the scope of this paper.

Tax Implications for Companies

It would appear that in light of a Draft Interpretation Note issued in March 2004, the South African Revenue Service (SARS) does not consider a share-based payment to constitute expenditure for any company concerned as they concluded [that]¹²:

¹⁰ International Financial Reporting Standard 2, *Share-based Payment*, paragraph 7

¹¹ International Financial Reporting Standard 2, *Share-based Payment*, paragraph 8

¹² Draft Interpretation Note, March 2004

“...it is quite clear that shares issued by a company in settlement of the purchase price of an asset or as payment for services rendered to the company, do not qualify as an expense actually incurred for income tax purposes, unless this is specifically provided for in the Income Tax Act”

Thus, in light of the above view, if a company acquired a revenue asset, for example trading stock, they would not be claim to claim a deduction as the requirements of section 11(a) of the Act would not be satisfied. If the asset acquired was a capital asset, then the company would have no cost nor would be there a base cost for CGT purposes.

It is submitted that the issue is not so easily resolved and this paper will focus its discussion on whether such payments do constitute expenditure for the company.

When interpreting the Act, one must give words their literal meaning. Rowlatt J, in a British Case, *Cape Brandy Syndicate v. Inland Revenue Commissioners* held, at 71, that¹³:

“in a taxing Act, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.”

The literal meaning of “expenditure”, as defined in the Oxford English Dictionary, is the “The action or practice of laying out, paying away, or spending (money), the expending or laying out (of energy, labour, time), the action or process of using up or consuming.”¹⁴ In essence, “expenditure” represents an outflow of resources embodying economic benefit. The payment of expenditure has the effect of diminishing the value of the company’s assets.

¹³ [1920] 1 K.B. 64

¹⁴ Oxford English Dictionary, www.oed.com Accessed 20 July 2005

Cash-settled share-based payments

It is submitted that any accounting expense, recognised as a result of a cash-settled share-based payment, would be allowed as a deduction as the company has incurred “expenditure” – they have laid out or spent money. The word “expenditure” is not restricted to the outlay of cash, however. It may take any form which has a “value in money or money’s worth”¹⁵. Thus cash-settled share-based payments settled by the issue of an asset other than cash would also constitute “expenditure” and thus be deductible under section 11(a). Where expenditure is not in cash, the value of such expenditure will be the cost of such asset to the taxpayer, excluding the value of his labour if the asset was manufactured or created by the taxpayer.

Equity-settled share-based payments

Unlike cash-settled share-based payments, the issue of whether a company has incurred any “expenditure” in an equity-settled share-based payment is unclear. It may be argued that the company has not incurred any expenditure in issuing shares as they have not expended or laid out any money or other assets. The effect of issuing shares is to dilute the value of the other shares in existence and this cost, the decline in value resulting from the extra number of shares in existence, is borne by the shareholders. Thus, the cost of issuing such equity instruments lies with the shareholder and not the company itself.

The counter-argument is that the company has incurred a debt which is simply met by the issue of shares. If this is the case, then the nominal value of the shares issued, and any share premium, must be classified as “expenditure” for deduction or allowance purposes.

A further argument, in favour of the view that there is “expenditure” for the company, is that although a company is, in law, a separate person, it cannot exist without its shareholders and, in effect the cost of such decline in value rests with the company.

¹⁵ Meyerowitz on Income Tax 2004/2005, paragraph 11.32

The only reported judgement found to have considered whether an amount constitutes “expenditure” is Income Tax Case 1783 (66 SATC 373). The facts in this case were that a taxpayer had entered into an agreement to purchase a business. The sale agreement stipulated that the value of the assets acquired would be fixed and the taxpayer would issue shares to discharge the value of the assets so acquired.

Judge Goldblatt held at 376, on the issue of whether the taxpayer had incurred “expenditure” as envisaged in section 11(a), that¹⁶:

““expenditure” in its ordinary dictionary meaning is the spending of money or its equivalent, *e.g.* time or labour and a resultant diminution of the assets of the person incurring such expenditure and an allotment or issuing of shares by a company does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders and in these circumstances such issue or allotment of shares does not constitute expenditure by the company.”

The judge, at 376, supports his decision by citing para 7.4 of *Silke on South African Income Tax* (‘*Memorial Edition*’) which states that [where a company remunerates an employee for services rendered]:

“Since the company has not lost or parted with any asset, it is submitted that it has not expended anything and that it is not entitled to claim as a deduction from income the nominal value of the shares issued to the employee. ... But when a company is obliged to allot shares in return for services rendered to it, there is no laying out or expending of any of its moneys or assets which, it is submitted, is an essential requisite or the words “expenditure actually incurred” in s 11(a). A similar problem arises when a company allots shares in return for trading stock.”

Silke on South African Income Tax (‘*Memorial Edition*’) goes on to say that regardless of the strict legal position, “SARS is prepared in practice to allow as a

¹⁶ Income Tax Case No 1783 66 SATC 373

deduction from the income of the company the nominal value of the shares it issues”. Given the position of SARS as expressed in the Draft Interpretation Note, the practice would appear to be changing.

Judge Goldblatt also found no evidence of the practice mentioned by *Silke on South African Income Tax* [stating at 377 that]:

" The appellant led no evidence of a practice by the South African Revenue Services to treat the issue of shares by a company as an expenditure by such company and the Commissioner's representative denied that any such practice existed."

The above case, while not binding, lends weight to the argument that the allotment of shares for services rendered (equity remuneration) is not "expenditure" as envisaged in section 11(a). The judge has applied a doctrine of interpretation and interpreted the word literally. A weakness of the judgement, with respect, is that no relevant (foreign) case law was considered. *Meyerowitz on Income Tax 2004, 2005* is of the opinion that the judgement is, with respect, incorrect saying "it is considered that this decision [Goldblatt] is wrong."¹⁷

This decision appears to contradict a reported decision from the Natal Income Tax Court¹⁸. Although this case dealt with the issue of whether certain payments were of a capital or revenue nature, and not explicitly as to whether the issue of shares constituted "expenditure", it is nevertheless relevant.

The facts of this case were that the taxpayer was a manufacturer who, during the year of assessment, had erected a new factory, installed the necessary plant and machinery and commenced with production. The taxpayer entered into an agreement with a firm of technical consultants and agreed to pay such firm 12 500 pounds. This was to be settled by the issue of 12 500 shares, each with a nominal value of 1 pound. The firm of experts would, in return, (a) provide technical knowledge, skill and services for the purpose of establishing the factory and supervising the erection and installation of the

¹⁷ Meyerowitz on Income Tax, 2004/2005, paragraph 11.32

¹⁸ Income Tax Case No 703 (1950) 17 SATC 208(N)

machinery and (b) thereafter provide, on an ongoing basis for a period of 10 years, technical expertise to help run the factory.

The issue in this case was whether the amount paid was capital or revenue. No mention was made as to whether the shares issued constituted expenditure although we can infer that since a pro rata deduction was allowed, the portion relating to (b) being held to be of a revenue nature and therefore deductible, the judge must have been of the opinion that the “expenditure” requirement was met.

Since we have no other cases in South Africa that deal specifically with this issue, guidance can be sought from the United Kingdom where this issue has surfaced on a number of occasions. The first decision, *Lowry v Consolidated African Selections Trust Ltd*, appears to support the view held by Goldblatt J as discussed above.

In this case, the respondent had issued shares to employees at a premium and had claimed that because these shares had been issued to staff in respect of services rendered, they were entitled to deduct the difference between the market value of these shares and the par value that the employees had paid. In dismissing this claim, the [3-2] majority held that the¹⁹:

“respondents had neither transferred money nor money's worth to the members of the staff, and therefore the sum in question could not be treated as a disbursement or an expense which could be deducted in computing their profits.”

The case points out, citing *Hilder v Dexter*, that the non-receipt of a [potential] premium is not expenditure:

“...Hilder v. Dexter establishes that the advantage which the allottee of shares at less than their market value gets is neither money nor money's worth belonging to the company. It follows, therefore, that the non-receipt of a premium which might have been obtained cannot be treated as an expense incurred by the company.”

¹⁹ 1940 2 All England Law Reports 545

Furthermore, the case reiterates that the question to be answered is simply whether the company has incurred an expense; the fact that there is [potentially] a taxable receipt for the employee is irrelevant [at 653]:

“I find no guidance from the fact that the employees have had to pay income tax on the premium value of their shares. The assessment on the employees was on the ground that holding an office or employment of profit they received a profit there from: the right to include a deduction of the amount in question in the trading account of the company for the purposes of Schedule D must be justified by a finding that the company incurred a trading expense.”

Viscount Caldecote L.C, in support of the majority, concludes by stating at 657 that:

“Its capital was intact after the issue of the shares: not a penny was in fact disbursed or expended. Its trading receipts were not diminished, nor do I think it is a right view of the facts to say that the respondent gave away money's worth to its own pecuniary detriment. The company was entitled to issue its shares at par. It did so, and the company never received, and never elected to receive, anything more than the par value of the share.”

Viscount Maugham, also in support of the majority view, is of the opinion that [at 662]:

“The company has not lost or parted with any asset. It has a fewer number of shares remaining for issue; but of course it can create as many more as it pleases. There is here in my opinion no transaction of trade at all, nor an item of any kind that ought to be carried to either side of the profit and loss account.”

He emphatically states at 662 that:

“The issue of shares by a company, whether at par or over, does not affect the profits or gains of the company for the purposes of income tax.”

It would thus appear that this decision, although dealing specifically with the issue of whether a [lost] premium is expenditure, would appear to support the argument that neither the premium nor the par value constitutes expenditure.

Meyerowitz, writing in *The Taxpayer*, is of the opinion that, although the language used “could be thought to preclude even the par value of the shares as constituting a disbursement or expense incurred”, on the specific facts of this case [it is] “not a persuasive precedent against the deduction of an amount by a South African company in respect of the issue of shares to its staff for services rendered or for the acquisition of trading stock or the cost of equipment and so on”²⁰.

The case law relied on by Meyerowitz to support his above-stated view can be found, firstly, in *Osborne Co Ltd v Steel Barrel*. In this case, the company had acquired assets with the acquisition of trading stock and the Crown held that where the company acquires stock for £10 000 in cash and fully paid up shares of £30 000, the shares cost the company nothing and therefore the value of the stock should be entered into the books at £10 000.

Lord Greene MR responded to the Crown’s contention as follows [at 637-638]²¹:

“It was strenuously argued on behalf of the Crown that, if a company acquires stock in consideration of the issue of fully-paid up shares to the vendor, that stock must, for the purpose of ascertaining the company’s profits, be treated as having been acquired for nothing, with the result that, when it comes to be sold, the Revenue is entitled to treat the whole of the purchase price obtained on the sale as a profit. This is a remarkable contention and it would require conclusive authority before we could accept it. The cases relied on in its support were *Inland Revenue Comrs v Blott* and *Lowry v Consolidated African Selections Trust Ltd*, neither of which, in our view has any bearing on this point. The argument really rests on a misconception as to what happens when a company issues shares as fully paid up for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but, when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when, in pursuance of such a transaction it agrees to credit the shares as fully paid, is giving up what it would otherwise have had, namely, the right to call on the allottee for payment of the par value in cash”

²⁰ Taxpayer 86, 2004

²¹ 1942 1 All England Law Report 634

He concluded by stating, at 637-638, [that]:

“A company cannot issue £1,000 nominal worth of shares for stock of the market value of £500, since shares cannot be issued at a discount. Accordingly, when fully-paid shares are properly issued for a consideration other than cash, the consideration moving from the company must be at least equal in value to the par value of the shares and must be based on an honest estimate by the directors of the value of the assets acquired.”

Further support for the view expressed in *Osborne Co Ltd v Steel Barrel* is to be found in *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd*. In this case, the company had purchased a portfolio of investments for a consideration settled with the issue of its shares at a premium and when the company disposed of its investments, the Crown disputed the base cost of this asset.

In a High Court decision, Judge Vinelott held that the base cost for CGT purposes is the market value of the shares in the taxpayer company when the agreement became unconditional, and not the figure attributed to those shares in the agreement [1168]²²:

“In retrospect, and with the benefit of Lord Greene MR’s analysis [*Osborne Co Ltd v Steel Barrel*], it can be seen that the argument advanced by the Crown was an absurd one. It amounted to saying that whenever a company acquires property (the relevant ‘property’ being in that case the benefit of the contract with the receiver) in exchange for the issue of shares then because it pays nothing in cash it gives nothing for the property.”

On appeal to the Appeal Court, Fox LG, reversing the decision of Vinleot, stated that the base cost should be the agreed upon price in the agreement [1434]²³:

“What then is the value of the consideration? The value cannot be less than the par value of the new shares; *Creddock (Inspector of Taxes) v Zevo Finance Co Ltd* is authority for that. But plainly it can be more since shares can be issued at a premium. The parties, in fact, agreed on a purchase price in the clearest terms. They agreed that the purchase of the portfolio should be at the price of

²² 1980 3 All England Law Report 221

²³ 1982 1 All England Law Report 121

£3.9 million. That price was to be satisfied by the issue of the new shares of 160 p per share credited as fully paid up.

The shares were, therefore, to be issued at a premium of 135p per share. The agreement of 21st September 1972 was an arm's length transaction. No attack was made by the Crown on its bona fides. No evidence was called before the commissioners to suggest that the figures in the agreement were in any way unreal or uncommercial. In those circumstances, we can see no reason for putting on the consideration given by Drayton any value other than that which the parties themselves, a leading insurance company and an investment holding company, honestly chose to put upon it. In *Craddock (Inspector of Taxes) v Zevo Finance* (1944) 27 Tax Case 267 at 295 Lord Simonds says:

'Then the agreement goes on to provide for the consideration moving from the ... company. I cannot distinguish between consideration and purchase price, and (using again the language of the Master of the Rolls) I find that, acquiring the investments "under a bona fide and unchallengeable contract", they paid the price which that contract required, a price which, whether too high or low according to the views of third parties, was the price upon which these parties agreed.'

Paragraph 4(1) of Sch 6 to the Finance Act 1965 refers merely to the 'amount or value of the consideration in money or moneys worth'. It seems to us that, on the facts of this case, the best evidence we have of the value of the consideration is the value which the parties themselves, in an arms length and bona fide transaction, agreed to put on it. We see no justification for disturbing that.

The result, in our view, is that the value of the consideration given by Drayton for the acquisition of the portfolio was £3.9 million.

In business terms we cannot regard that as an unsatisfactory conclusion. Commercial firms agree on a sale and purchase of assets at a specified price. There is nothing to suggest that it is not a wholly genuine arms length

transaction on commercial terms. In these circumstances, it seems to us realistic that the agreed purchase price should be the value of the consideration given by the purchaser and should provide the base value of the asset for capital gains tax purposes when the purchaser subsequently disposes of the asset.”

IFRS 2 also deals, albeit very briefly, with this issue. Unfortunately, the Basis for Conclusions fails to provide any reason as to why there is a cost to the company stating simply that “irrespective of whether one accepts that there is a cost to the entity, an accounting entry is required”²⁴.

Addressing the issue as it relates to equity-settled share-based payments, in light of the above discussed case law, this report will address two distinct types of equity-settled share-based payments; the first being where the company issues shares as consideration for the acquisition of an asset and the second being where a company issues shares, options or other equity instruments to its employees.

Equity-settled share-based payments – assets acquired

In this context, the debate surrounding whether we have “expenditure” is no longer necessary given the introduction of section 24B – *Transactions where assets are acquired in exchange of shares issued*. This section was introduced into the Income Tax Act by Act No. 32 of 2004 and is deemed to have come into operation on 1 October 2001 (the significance of this being that it establishes a base cost for CGT purposes).

Section 24B(1) states that “if a company acquires any asset from any person in exchange for shares issued by that company –

- (a) that company is for the purposes of this Act deemed to have actually incurred an amount of expenditure in respect of the acquisition of that

²⁴ International Financial Reporting Standard 2, *Share-based Payment*, Basis for Conclusions, paragraph 42

asset, which is equal to the market value of that asset as determined at the time of acquisition

Thus, if a company were to acquire any asset, be it trading stock, property, plant and equipment etc., and issue shares to settle the consideration thereof, the market value of such shares would constitute expenditure for the purposes of the Income tax Act. This expenditure would then be deductible under section 11(a), if the asset acquired were of a revenue nature (trading stock, for example) or, if the asset were of a capital nature, this expenditure would be the “cost” for the purposes of the relevant capital allowance section. This expenditure would also form part of the base cost when the asset is sold (for CGT purposes).

The principles embodied in this new piece of legislation appears to be consistent with the principles set out in English case law decisions; *Osborne Co Ltd v Steel Barrel* and (Fox LJ’s decision in) *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd*, which support the view that where a company acquires assets with the issue of shares, the value to be placed on the assets so acquired “must be based on an honest estimate by the directors of the value of the assets acquired” (*Osborne Co Ltd v Steel Barrel*). The term “market value” is, it is submitted, the honest estimate of an asset’s worth.

It may be argued that the introduction of specific legislation, and the subsequent fact that expenditure is “deemed to have [been] actually incurred”, adds weight to the argument that the issue of shares by a company does not result in expenditure for such company. This fact notwithstanding, the introduction of section 24B makes the argument redundant for these types of transactions.

Equity-settled share-based payments – Payments to Employees

We now also have legislation, although it is far more restrictive than section 24B, for transactions where a company issues shares or options to employees for services rendered (or to be rendered in the future). Section 11(IA), which came into effect from 26 October 2004, allows a company to deduct from its taxable income “an

amount equal to the market value of any qualifying equity share granted to an employee of that person as contemplated in section 8B”.

Section 8B defines a “qualifying equity share” as an equity share that has been acquired in terms of a “broad-based employee share plan, where the market value of all equity shares...which were acquired...in that year and the two immediately preceding years of assessment does not in aggregate exceed R 9000”. Section 8B(3) defines a “broad based employee share plan” as a plan in terms of which –

- a) equity shares in that employer, or in a company in the same group of companies as the employer, are acquired by employees of that employer, for consideration which does not exceed the minimum consideration required by the Companies Act, 1973 (Act No. 61 of 1973);
- b) employees who participate in any other equity scheme of that employer or of a company in the same group of companies as that employer are not entitled to participate and where at least 90 per cent of all other employees who are employed by that employer on a permanent basis on the date of grant (and who have continuously been so employed on a full-time basis for at least one year) are entitled to participate;
- c) the employees who acquire the equity shares are entitled to all dividends and full voting rights in relation to those equity shares; and
- d) no restrictions have been imposed in respect of the disposal of those equity shares, other than -
 - i) a restriction imposed by legislation;
 - ii) a right of any person to acquire those equity shares from the employee at market value; or
 - iii) a restriction in terms of which that employee may not dispose of those equity shares for a period, which may not extend beyond five years from the date of grant;

A proviso to section 11(1A), however, limits the deduction to R3 000 per employee per annum with any excess allowed to be carried over to the following year of assessment. While this section provides some relief, the requirement that the “market

value not exceed R9 000” is too small to be of any substantial relief for major companies. Large companies are unlikely to obtain any benefit from this new piece of legislation as they are unlikely to introduce schemes where they can issue only 500 shares to an employee.

A further argument, however, is that the far wider section 24B applies to these transactions too; the argument being that the services rendered, for which the shares were allotted, constitute an asset in the hands of the company. If we consider the accounting position, the view in terms of the Basis of Conclusions contained in IFRS 2, is that “services are assets when received. These assets are usually consumed immediately [thus they do not qualify for recognition as assets in terms of the accounting framework]. This is explained in the FASB Statement of Financial Accounting Concepts No.6 Elements of Financial Statements: ‘services provided by other entities, including personal services cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily²⁵’”. In accounting terms, therefore, they are an asset.

Section 24B, unfortunately, does not define “asset” and the only guidance is to be found in the 8th Schedule to The Act where, for CGT purposes, an asset is defined to include -

- (a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- (b) a right or interest of whatever nature to or in such property.

The Oxford English Dictionary defines “incorporeal” as meaning [in law] “*Law*. Having no material existence in itself, but attaching as a right or profit to some actual thing”²⁶. The company has the right to receive the profit that is generated from the work performed by the third party.

²⁵ International Financial Reporting Standard 2, *Share-based Payment*, Basis for Conclusions, paragraph 47

²⁶ Oxford English Dictionary, www.oed.com Accessed 20 July 2005

One could argue, simplistically, that the services rendered must constitute an asset in the hands of the company as the services rendered have obvious value for the company. Why else would the company be paying for these services?

Supporting evidence for this argument can be found in The Companies Act requirements in respect of companies wishing to issue shares. Sections 81 of the Companies Act, *Issue of shares of par value at a discount*, sets out certain criteria, including authorisation by special resolution and court sanction, that must be satisfied before a company may issue par value share at a discount while section 82, *Issue price of shares of no par value requiring special resolution*, states that: “no company shall issue shares having no par value of a class of shares already issued and at a price lower than an amount arrived at by dividing that part of the stated capital contributed by already issued shares of that class, unless the issue price of such shares is authorized by a special resolution”.

Furthermore, section 92, *Shares not to be allotted or issued unless fully paid-up*, states that: “No company shall allot or issue any shares unless the full issue price of or other consideration for such shares has been paid to and received by the company”.

It is submitted that since companies are allowed to allot shares to employees, the service that they received, in return, makes those shares fully paid up. In other words, the company receives payment in the form of services from the employee. Thus, those services are clearly an asset in that the company attaches value to such services.

A detailed discussion on whether the service(s) rendered by an employee to its employer constitutes an asset for the purposes of section 24B is beyond the scope of this report.

Choice of settlement

Looking finally at share-based payments where either the entity, or the supplier of such goods or services, has the choice of whether the entity settles the consideration in cash, or other assets, or by issuing equity instruments, it is submitted that the tax treatment would depend on who had the choice.

If the company has the choice, then there is [potentially] no expenditure unless they chose to settle with the issue of cash, or other assets. Where, however, the third party has the right to decide on the method of settlement, it is submitted that there is expenditure. As an example, if the employee was to agree to work for a cash salary but subsequently changes their mind and decides to use such mentioned salary to subscribe for shares in the company, then there is expenditure for the company. In this situation, expenditure has been incurred, notwithstanding the fact that the obligation is so settled by the issue of shares.

Viscount Maugham, in *Lowry v Consolidated African Selections Trust Ltd*, appears to agree with this statement stating at 662 [that]:

“I am quite ready to accept the view that the amount of the debt or liability so discharged will find its way into the profit and loss account on ordinary commercial principles and will pro tanto reduce the profits for the year for income tax purposes. A man's salary with his consent can be paid in meal or malt as well as in money, and that salary is one of the items of expenditure which go to reduce the amount of the profits and gains”

International Practice

If we consider the position abroad, using Australia as an initial example, the tax authority has decided not to allow a deduction for share expenses arising from the introduction of IFRS 2. A Treasury press statement, released on April 26 2004, states that “...under the current law an income tax deduction is not available as the normal basis for providing a taxation deduction is that a business has incurred an economic

loss or outgoing. It is the Government's view that the current treatment should remain and that there be no new income tax deduction for the issuing of options.”

The press statement confirms that there are no plans to alter the status quo and give a deduction generally; [stating that] “allowing a deduction for options issued to employees beyond the concessions currently available for employee share schemes would have a significant negative impact on Government revenue”

Like South Africa, however, a deduction is allowed for “certain qualifying options issued under employee share schemes”. This is the position in the United Kingdom as well where the tax authority has introduced specific legislation that allows a deduction for certain qualifying schemes.

The UK legislation is, however, far more comprehensive than the current relief available in terms of section 11(1A).

Conclusion

A popular method that companies employ to pay for goods and services is to issue shares. Equity remuneration is especially prevalent, largely for executive management, as the company wants to give their employees a stake in the company thereby linking the success of the company with that of the individual.

With regards to cash settled share-based payments, it is submitted that there is expenditure for the company in that they have laid out or expended cash and/or an asset having value in money or money’s worth.

With regards to equity-settled share-based payments, specifically the acquisition of assets with the issue of shares, specific legislation has put an end to the debate of whether it is expenditure for the company issuing the shares. When a company acquires an asset with the issue of shares, there is now deemed to be expenditure in terms of section 24B; such expenditure being equal to the market value of the asset(s)

so acquired. Furthermore, this section is backdated to 1 October 2001 thereby giving a base cost to capital assets.

The uncertainty surrounding the issue of whether an equity settled share-based payment to employees and/or third parties for services rendered constitutes “expenditure” for the company remains unresolved. While the introduction of section 11(IA) has provided some clarity, this relief only applies to “qualifying-equity share schemes” and is very restrictive. Further, wider-ranging, legislation needs to be introduced to clarify the issue failing which guidance must be sought from our judges as the issue is played out in court.